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SUBJECT: ENGAGING THE NEW MEXICAN ADMINISTRATION ON
DEVELOPMENT AND ENVIRONMENTAL ISSUES

REF: MEXICO 3322 AND PREVIOUS

¶1. Summary: This is the fifth in a series of six cables on transition issues in Mexico. The central development challenge for Mexico - and perhaps the main challenge for its new president -- is reducing the poverty that continues to afflict so many here and which drives so many to emigrate. Complicating that task is the fact that Mexican competitiveness has been slipping. Fixing that will require local infrastructure development (which in turn requires capital), unleashing the potential of small businesses, and improving education. Mexico in addition faces a number of environmental challenges, some of which, such as border water issues, impact directly on the U.S. End summary.

Development

¶2. Mexico faces a steep development challenge. Despite recent progress in reducing levels of extreme poverty, perhaps a quarter of Mexico's 100 million citizens still live on less than four dollars a day. The lack of viable infrastructure hampers economic development, particularly in rural areas. Each year hundreds of thousands of university graduates spill out into an economy that has not created enough jobs. Mexico's natural resources such as water and forests that are essential to the country's long-term future and greater prosperity in rural areas are being depleted. Mexico's meeting this mounting challenge head-on is ultimately the key to stemming the seemingly boundless migration north of millions of its citizens in search of better jobs and wages. Mexicans want more and better opportunities in their own country - the new president will have to address this as Job One.

¶3. Mexico's development challenge at its core is the country's steadily slipping global competitiveness standing. Reversing the trend is clearly a Mexican responsibility. But as Mexico's challenge is inextricably linked to the migration issue, the U.S. can and should play a catalytic role in helping its neighbor strengthen competitiveness, increase prosperity, and create jobs here. The USG should target assistance and engage with the new administration early to focus on Mexico's competitiveness, a topic that resonates with all three major presidential candidates. Investors and economists would point to a long and broad list of issues as essential factors in Mexico's development challenge and improving competitiveness. We propose just the following three themes for immediate engagement with the new administration: unleashing local infrastructure development; small business as the engine of growth; and education and a

competitive work force

Unleashing Local Infrastructure Development

¶4. Mexico has a significant infrastructure deficit. This can be addressed by increasing state and city access to Mexico's dynamic capital market. Although the market is open to state and municipal borrowers, private rating agencies believe it can go much further - and ultimately become the largest municipal bond market in the world after the U.S. To tap Mexico's full potential, two key features of the U.S. market -- municipal bond insurance and federal tax-exemption - are worth exploring.

¶5. Engagement: All of the potential winners of Mexico's July 2 presidential election have promised job creation. They have clearly and correctly linked the issue to migration. Whoever the winner is, he will need to move quickly to show results on this front, and his success or failure here will define his administration. If the USG can offer advice and modest support to efforts to generate private sector investment in the infrastructure improvement needed for job creation, this will be an attractive prospect to new administration hungry for good ideas.

¶6. Activities:

-- We should offer the new GOM economic team a high-level seminar on the potential for municipal bond insurance in Mexico, including top U.S. Treasury and SEC officials, as well as rating agencies and investment banks.

-- In the U.S. federal tax-exemption translates to lower interest rates and cost savings for taxpayers. Mexican
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states and municipalities currently pay 15 percent in value-added-tax on their financing transactions. We should propose that the new president order a study to look at the impact of tax exemption for state and municipal infrastructure financing. If this study concludes that the long-term benefits of tax exemption override short-term revenue concerns, and if the bond insurance feature resonates with the GOM, we are prepared to provide assistance to them to implement either or both changes.

Small Business as the Engine of Growth

¶7. The growth of the small business sector has been the key to economic expansion and job creation virtually everywhere. Small and medium enterprises (SMEs) in Mexico account for almost half of the country's employment and 50 percent of its GDP. Yet, the sector still faces serious obstacles.

¶8. Engagement: We should propose a high-level discussion on SME development for the transition team, followed up with a bilateral cabinet-level meeting within the first six months of the new presidential term involving a range of Mexican and U.S. agencies, as well as key chambers and business associations. The goal would be to focus attention and attain greater coordination on small business among the GOM's and other donor programs.

¶9. Activities:

-- The new administration should be encouraged to do more to improve the policy environment at the micro-level to facilitate SME operations (including access to credit) and permit continuous entry of new entrepreneurs.

-- We recently financed a World Bank Doing Business survey here to measure how Mexican cities treat key issues like business registration and contract enforcement. Doing Business generated wide interest, and the GOM plans to use it as an annual survey comparing all 32 states. With this as a guide, we can approach the new administration, offering

assistance to help them make the most pressing policy improvements.

Education and a Competitive Work Force

¶10. Access to quality education is fundamental to competitiveness. While Mexico has advanced significantly in terms of access, a significant gap in the quality of education remains between rural and urban areas.

¶11. Engagement: The U.S. should support Mexico strategically in closing the gap, echoing President Bush's enhanced emphasis on education and the competitiveness theme, and building on our experience with our widely supported Education USA and university partnership programs.

¶12. Activities:

-- The Mission would look to support the new government's education team in attaining the lofty goals already set for quality education in rural schools.

-- The U.S. should engage with private organizations and firms (Intel for example, is working with us to identify areas for investment) in partnerships to support the implementation of the Education Secretariat's (SEP) Technology in the Classroom program in Grades 1-4.

-- In higher education, the U.S. should expand university partnerships with Mexico that target competitiveness areas, for example co-sponsoring with the Mexican National Science Commission (CONACYT) scholarships, joint research, and both faculty and student exchanges in key science and technology areas.

The Environment

¶13. Environmental degradation and pollution impose a serious drag on economic growth, incurring high costs and diverting resources that could be better used to increase competitiveness. Three issues - the border environmental picture, air quality, and water -- merit early attention as we engage with the new administration. Commercial promotion

of leading-edge U.S. environmental technology and services will complement our efforts on these issues.

¶14. Engagement: There is no more important place to start than where our countries physically come together - along a 2,000-mile border. Border 2012 is the third border plan between U.S. and Mexican environmental authorities, but the first to cover a ten-year planning horizon and to publish hard numerical goals for each country to improve health and the environment on the border. Border 2012 is widely supported by state, municipal, and other partners who formed this common agenda to address fundamental border issues. The Mexicans are again falling behind in their water deliveries to the Rio Grande Valley. The State of Texas has begun to notice the low level of deliveries and is pushing for talks. Mexico will need to deliver almost 600,000 acre-feet before the current five-year delivery cycle ends in September 2007 to avoid another deficit situation. While air quality in Mexico City has improved, it remains an issue - here and in other cities. Regulations are in place for gasoline, cars that take advantage of low sulfur fuel, and diesel engines. However these regulations will not be implemented if funding is not made available for converting refineries.

¶15. Activities:

-- As we near the halfway point, we recommend the USEPA Administrator meet in October or November with Mexico's new environmental players to review results of Border 2012 and renew our mutual commitment to the plan.

-- To avoid an unnecessary irritant in US-Mexican relations,

the new Mexican government should be strongly encouraged by senior Department of State officials to deliver sufficient volumes of water in the remaining months of this cycle to fulfill its treaty obligation.

-- The U.S., via the SPP environment and trade working group, should urge continued support for the refining of ultra-low sulfur fuels.

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